JAMES M. TALENT, MISSOURI
CHAIRMAN

NYDIA M. VELÁZQUEZ, NEW YORK

Congress of the United States

House of Representatives

106th Congress

Committee on Small Business

2361 Rayburn House Office Building

Washington, DC 20515-0315

July 19, 2000

Ms. Magalie Roman Salas
Secretary
Federal Communications Commission
445 12th Street, S.W., Room TW-B204
Washington, DC 20554

RE: In the Matter of Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, CC Docket No. 96-98.

Dear Ms. Roman Salas:

Pursuant to § 1.1206 of the Commission's rules, please find enclosed two copies of an ex parte written communication in the above-referenced docket. Please direct any questions concerning this filing to Barry Pineles at 202-225-5821.

Sincerely,

James M. Talent
Chairman

Enclosures

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Hon. William Kennard
Chairman
Federal Communications Commission
445 12th Street, S.W., Room 814
Washington, DC 20554

RE: In the Matter of Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, CC Docket No. 96-98.

Dear Chairman Kennard:

On November 5, 1999, the Commission issued the *Third Report and Order* in the above-referenced docket. One aspect of that decision, the determination to prohibit competitive local exchange carriers ("CLECs") from obtaining unbundled switching to serve customers with four or more local telephone lines, is particularly troubling because the Commission issued the decision without following proper procedure or fully understanding the impact that the proposal will have on the ability of small business users to benefit from competition in the local exchange market. I understand the Commission is reconsidering this decision. In doing so, the Commission should follow proper procedure, reduce barriers to entry of small CLECs, and ensure that small businesses receive the benefits of competition resulting from the implementation of the Telecommunications Act of 1996.

There are a number of alternatives for achieving the goal of maximizing the benefits of competition to small businesses while minimizing the burdens on small providers of telecommunication services including: a) raising the limitation on the availability of switching as an unbundled network element to the DS-1 level; b) allowing competitors to obtain unbundled switching whenever they plan on serving a small business as that term is defined by the regulations of the United States Small Business Administration implementing the Small Business Act; or c) designating switching as an unbundled network element but allowing an incumbent local exchange carrier ("ILEC") to demonstrate that switching is available from competitors at comparable rates and at levels of service (i.e., five lines, ten lines, DS-1, DS-3) in which case the ILEC need not make

switching available on an unbundled basis at that service level but still would be required to make it available at lower levels of service.

I. The Commission Decision on Switching as an Unbundled Network Element

The Telecommunications Act of 1996 requires ILECs to offer access to the individual elements of their networks if such access is necessary and the failure to provide access would impair the ability of competitors to provide the services they seek to offer (generally referred to as the "necessary and impair" standard). In the *First Report and Order* in this docket, the Commission determined that ILECs had to offer local switching on an unbundled basis. In *AT&T Corp. v. Iowa Utilities Board*, the Supreme Court found that the Commission did not provide an adequate explanation of its list of network elements to be offered on an unbundled basis. The Court directed the Commission to revisit this issue.

On November 5, 1999, the Commission issued its decision on remand from the Supreme Court. The Commission reaffirmed its initial determination that the failure to provide access to the local switch would impair the ability of competitors to provide local exchange service. However, the Commission limited that finding to situations in which competitors wanted to offer service to customers who had three or fewer local telephone lines or for customers of any size outside the top fifty metropolitan areas. For customers who purchased four or more telephone lines in these areas, the Commission concluded that these customers were not small businesses and competitors wanting to serve these medium and large businesses had options, other than the ILEC, from which to obtain switching on an unbundled basis.

A close review of the Commission's decision reveals a number of problems. First, the Commission failed to assess, as required by the Regulatory Flexibility Act, the impact that the proposed decision would have on the small businesses seeking to compete with ILECs by purchasing network elements separately, packaging them and selling the package (generally referred to as "UNE-P") to users of local exchange service. Second, the Commission's decision appears to violate § 3(a)(2) of the Small Business Act requiring that the adoption of a size standard other than that already promulgated by the Administrator must be subject to notice and comment and approved by the Administrator. Third, the Commission's decision violated § 257 of the Telecommunications Act of 1996 by establishing new barriers to entry for small telecommunications companies rather than eliminating them. Finally, the Commission failed to analyze how limitations on the availability of local switching would delay or prevent competition from developing in the market for small business customers.

Given these flaws, I believe that the Commission must modify the limitation in the *Third Report and Order* in order to maximize the benefits of competition to providers and users of telecommunication services. In doing so, the Commission should make switching available on an unbundled basis to serve all customers in the top fifty metropolitan regions while it undertakes the steps necessary to comply with the Regulatory Flexibility Act, the

Small Business Act, and the market-opening provisions of the Telecommunications Act of 1996. After the Commission has complied with proper procedures, it will then have the necessary data to delineate when local switching needs to provided on an unbundled basis by the ILEC. The record in this docket, as well as the requirements of Congressional mandates, certainly militates in favor of cut-off substantially higher than that set forth in the *Third Report and Order*.

II. The Commission Violated the Regulatory Flexibility Act

The Regulatory Flexibility Act requires an agency to assess the impact of its final rules on small businesses. If an agency determines that there will be a significant economic impact on a substantial number of small businesses, it must prepare a final regulatory flexibility analysis that examines alternatives to the proposal that are less burdensome on small businesses. In addition, the final regulatory flexibility analysis must specify what steps the agency took to minimize any adverse consequences on small businesses and why it failed to adopt alternatives that reduced such burdens.

The Commission's final regulatory flexibility analysis can be broken into two distinct aspects. One is an assessment of the potential number of entities affected by the proposal. The Commission correctly concludes that there are a significant number of small businesses in or seeking entry into the provision of local exchange service. The second aspect is the assessment of the impact and the Commission notes that the overall impact of the final rule will be positive because it enables small businesses to more easily enter the local exchange market. This conclusion is misleading because the Commission failed to assess the impact of certain individual actions set forth in the *Third Report and Order* that would have a significant economic impact on a substantial number of small businesses.

Little doubt exists and the Commission cannot dispute that many small businesses have entered the local exchange market since the enactment of the Telecommunications Act of 1996. These small businesses, like their counterparts that entered the long-distance market after the divestiture of the Bell Operating Companies by AT&T, do not focus on large business customers. Rather, they seek to fill market niches, including the provision of service to many other small business customers.

Many of these smaller businesses determined that it would be easier to enter the market for local exchange service without trying to duplicate, in whole or in part, the ILEC's network;[1] a similar strategy was utilized by many small businesses that entered the

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[1] The costs of building the necessary infrastructure to provide service in the local exchange market without some resale of ILEC services would foreclose competition because no one could immediately duplicate the network of the incumbent and, without access to a ubiquitous network, no existing customer of the incumbent would ever switch service. Even building a partial network can be prohibitively expensive and time-consuming. Given this reality, the Supreme Court and the Commission recognized the validity of a competitive entry strategy based on bundling various ILEC network elements together using UNE-P or through resale of ILEC services bought at wholesale.

long-distance market after divestiture. But unlike their counterparts in the long-distance industry who utilized a resale strategy, purchasing service from facilities-based carriers at wholesale and reselling it is not an effective strategy for the local exchange market. Almost every provider that has tried to effectuate a pure resale strategy based on the wholesale discounts recommended in the *First Report and Order*, and subsequently developed by the states, simply provided a return of zero or less than zero. Therefore, small businesses interested in entering the local exchange market adopted a UNE-P strategy by purchasing the individual network elements, bundling them, and then selling the package to customers.

The Commission's decision in the *Third Report and Order* limits the ability of small CLECs wishing to serve small business customers whose needs are larger than a residential subscriber but smaller than the business user who has sufficient capacity to order DS-1 service. CLECs wishing to utilize UNE-P can obtain certain capabilities from providers other than the ILEC, such as directory assistance and operator services. However, given the economics of provisioning local exchange service, switch-based competitors have not found it economic to offer competitive switching to other carriers wishing to serve customers with service requirements below DS-1.[2] Absent the ability to purchase local switching on an unbundled basis from the ILEC, competitors will be foreclosed from utilizing UNE-P as an entry strategy. More importantly, small businesses whose requirements for service are greater than three local lines but less than DS-1 will not see the benefits of competition.

There can be no more significant economic impact on small businesses than a prohibition on entering a market. The Commission's decision effectively forecloses the opportunity for numerous small telecommunications providers to serve small businesses in the top fifty metropolitan areas. The Commission's final regulatory flexibility analysis is flawed because it failed to consider the impact that its decision would have on small CLECs. Had the Commission performed a proper regulatory flexibility analysis, it would have developed alternatives, including expanding the availability of local switching as an unbundled network element, that were less burdensome on small CLECs but still met the "necessary and impair" standard set forth in the Telecommunications Act of 1996.

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[2] One aspect of transferring service involves the cut over from the ILEC to the new competitor. ILECs are able to process electronically new orders up to the DS-1 level. Competitors seeking to switch a customer must process the transfer of each line manually, by physically disconnecting and then reconnecting the lines. Obviously, this is a costly, labor intensive process. However, for customers seeking service at the DS-1 level or higher, even ILECs must process and connect lines on a manual basis, in part due to the customer premises equipment needed to offer service at such levels. Nor is the process of initiating service the only point at which scale economies exist in the provision of telecommunication services. Traffic sensitive equipment costs also demonstrate scale economies. For example, the Commission notes that the cost of switching equipment on a per-customer basis is much lower for higher levels of service. *Third Report and Order* at ¶¶ 259-67.

III. The Commission Violated the Small Business Act

The Commission determined that any business which has more than three local exchange telephone lines no longer constitutes a small business at least for purposes of obtaining telecommunication services. That determination is factually incorrect. The Commission baldly asserts that small businesses have the same telecommunications needs as residential customers, but has no data upon which to base that conclusion.[3] An obvious example, such as a neighborhood restaurant, demonstrates the fallacy of the Commission's conclusion. The restaurant might have a telephone line for reservations, another to handle delivery and takeout orders, a third for a fax machine, and a fourth line for the owner to manage the restaurant. In an era of burgeoning business-to-business electronic commerce, a line dedicated to Internet activity for ordering supplies and food certainly would not be uncommon. The restaurant, which cannot be considered a large business, nevertheless would be considered a medium or large user of telecommunication services, even if it had the minimum amount of lines necessary to adequately conduct its operations. This patent contradiction simply demonstrates a complete absence of Commission data on how small businesses utilize the public switched telephone network.

Even assuming the Commission's decision is correct (and no evidence exists that it is), the Small Business Act prevents an agency from classifying a business as small without following proper procedures. Section 3(a)(2)(C) of the Small Business Act, 15 U.S.C. § 632(a)(2)(C), provides that "[u]nless specifically authorized by statute no Federal department or agency may prescribe a size standard for categorizing a business concern as a small business concern...." Compliance with § 3(a)(2)(C) requires that the agency put out the proposed size definition for notice and comment, explain why it has chosen the specific definition, and then obtain the approval of the Administrator of the United States Small Business Administration. This process is not alien to the Commission because it has followed the strictures of § 3(a)(2)(C) when developing size standards for the conduct of spectrum auctions pursuant to § 309(j) of the Communications Act of 1934. Despite the Commission's familiarity with the procedures set forth in the Small Business Act, nothing in the record demonstrates that the Commission sought notice and comment of its definition as the appropriate demarcation between large and small businesses or obtained the approval of the Administrator. Therefore, the Commission's action to delineate a different definition of small business than that used by the Administrator is arbitrary and capricious. If the Commission had complied with the procedures in the Small Business Act, it would have garnered appropriate data which it could use in a variety of circumstances (not limited to this rulemaking) that would have permitted it to make a reasoned delineation between small business users of telecommunication services and medium or large business users of telecommunication services.

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[3] *Id.* at ¶ 293.

IV. The Commission Violated § 257 of the Telecommunications Act of 1996

Section 257(a) of the Telecommunications Act of 1996 required the Commission to eliminate market entry barriers for entrepreneurs and other small businesses interested in owning and operating telecommunication services. Section 257(c) mandates that the Commission study these market entry barriers every three years. The obligation to promote competition and eliminate unnecessary burdens on the ability of small businesses to compete in the telecommunications market is an ongoing obligation of the Commission. Rather than eliminating a barrier to entry by small telecommunications companies, the Commission's decision in the *Third Report and Order* erected a new barrier to entry. The decision contravenes § 257 and the Commission should reconsider its decision, including expanding the availability of switching as an unbundled network element in order to promote UNE-P as a less capital intensive means of entry for small businesses and entrepreneurs into the local exchange market.

V. The FCC Failed to Consider the Impact on Small Business Users

The primary purpose of the Telecommunications Act of 1996 was to eliminate regulatory barriers that prevented full and open competition in the local exchange market. The beneficiaries of this competition were not providers but users of telecommunication services. The Commission's decision in the *Third Report and Order* limits the benefits of the Telecommunications Act of 1996 by reducing the potential number of competitors willing to serve small business users who do not need levels of service at DS-1 or higher. As already noted, facilities-based competition to ILECs requires scale economies that simply are not achievable in serving customers needing less than DS-1 service. And absent the availability of switching as an unbundled network element from the ILEC, UNE-P based competition will not succeed. It seems odd indeed that the Commission would establish a regulatory regime that potentially confines hundreds of thousands of small businesses in the top fifty metropolitan areas to only one provider of service while residential customers, business customers needing high-capacity services, and small businesses in areas outside the top fifty metropolitan areas may have a plethora of choices. Small businesses in the largest metropolitan areas, including many minority and women-owned businesses, deserve the same opportunity to benefit from competition as other users of telecommunication services. The Commission must reexamine the restriction on the availability of switching to ensure that small businesses in the top fifty metropolitan areas also will have a choice of providers.

VI. A Number of Alternatives Exist that can Minimize Burdens on Small Providers while Maximizing the Benefits of Competition to Small Business Users

The decision in the *Third Report and Order* highlights the problems that Congress sought to avoid when it established specific analytical requirements and procedures for considering the impact of the Commission's decisions on small businesses. The

Commission would have been obligated to obtain data upon which it based decisions concerning the availability of local switching from providers other than the ILEC. The Commission would have had information on how small businesses utilized the public switched telephone network. With this data, the Commission would have been prepared to make a more reasoned determination concerning the availability of local switching as an unbundled network element for competitors seeking to serve small business customers.

The Commission then could have examined a number of alternatives to minimize the adverse consequences of its decision while maximizing the benefit to hundreds of thousands of small business users. For example, one sensible alternative, given the economics of the local exchange market, would be to raise the limit on the availability of switching so that any competitor seeking to serve customers with service requirements below the DS-1 level would be able to obtain ILEC switching on an unbundled basis. In lieu, the Commission might consider allowing a competitor to obtain switching from the ILEC on an unbundled basis whenever the competitor wants to serve a small business customer who satisfies the definitions and regulations of the United States Small Business Administration, 13 C.F.R. Part 121. This alternative would eliminate the problem of the Commission having to delineate new standards for defining a small business concern. Or the Commission may designate switching as an unbundled network element in the top fifty metropolitan (as it has throughout the rest of the country) but allow ILECs on an individual basis to demonstrate that switching is available from competitors at comparable rates and levels of service. Thus, an ILEC would have to provide local switching unless it could demonstrate that switching was available from competitors at comparable rates and terms of service. For example, if an ILEC could demonstrate that switching is available from competitors at the ILEC's rates for those businesses which have ten or more telephone lines, the ILEC would not be required to provide switching on an unbundled basis for those competitors seeking to serve customers with ten or more lines. However, the ILECs still would be required to provide unbundled switching to those competitors wishing to provide service to businesses with nine or fewer telephone lines. Of course, there may be other alternatives that achieve the goals of the Regulatory Flexibility Act, the Small Business Act, and the Telecommunications Act of 1996 and the Commission should properly investigate those as well.

VII. Conclusion

The primary objective of Congress in enacting the Telecommunications Act of 1996 was to ensure the development of a competitive local exchange market. The Commission's limitation on switching as an unbundled network element hinders the achievement of the laudable goals of the Telecommunications Act of 1996. In particular, the decision specifically carves out small businesses in the top fifty metropolitan areas from obtaining the maximum benefits of competition. Had the Commission followed proper procedure it would have identified the flaws in the *Third Report and Order* and uncovered alternatives that would not unduly burden small telecommunications providers. More importantly, those alternatives would increase the likelihood that small business users of telecommunications would have an array of alternative providers.

Pursuant to Commission rules concerning ex parte communications, two copies of this letter have been submitted to the Secretary for inclusion in the docket. Should you have any questions concerning this letter, please contact Barry Pineles of the Committee Staff at 202-225-5821.

Sincerely,

James M. Talent
Chairman

cc: Hon. Harold Furchtgott-Roth, Commissioner
Hon. Susan Ness, Commissioner
Hon. Michael Powell, Commissioner
Hon. Gloria Tristani, Commissioner
Dorothy Atwood, Chief, Common Carrier Bureau